BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
Chairman

JIM IRVIN
Commissioner

WILLIAM A. MUNDELL
Commissioner

JEFF HATCH-MILLER
Commissioner

MIKE GLEASON
Commissioner

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AN ORDER OR ORDERS AUTHORIZING IT TO ISSUE, INCUR, OR ASSUME EVIDENCES OF LONG-TERM INDEBTEDNESS; TO ACQUIRE A FINANCIAL INTEREST OR INTERESTS IN AN AFFILIATE OR AFFILIATES; TO LEND MONEY TO AN AFFILIATE OR AFFILIATES; AND TO GUARANTEE THE OBLIGATIONS OF AN AFFILIATE OR AFFILIATES	DOCKET NO. E-01345A-02-0707

INITIAL POST-HEARING BRIEF OF PANDA GILA RIVER, LP

JANUARY 27, 2003

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I. INTRODUCTION

Panda Gila River, L.P. ("PGR") is participating in this proceeding in order to lend its voice and its resources to help foster a vibrant and competitive wholesale electricity market in Arizona. It is in the best interests of Arizona ratepayers for PGR to do so. Contrary to Arizona Public Service Company's ("APS") repeated assertions, this proceeding could very much influence the prospects for achieving meaningful wholesale competition in Arizona. Contrary to APS's assertions, outright approval of APS's financing application, especially without conditions, would potentially (a) significantly increase the likelihood of APS eventually owning the Pinnacle West Energy Corp. ("PWEC") assets and, therefore, acquiring substantially more generation than it has presently, a result directly contrary to the public policy goals expressed in the Arizona Corporation Commission's ("Commission") Electric Competition Rules; (b) significantly increase the likelihood of APS being allowed to rate-base those assets; (c) significantly decrease the amount of APS load that APS neither presently serves nor plans to serve by APS-owned generation in the future; and, therefore (d) substantially reduce the amount of APS load for which non-affiliated suppliers otherwise could compete pursuant to the Track B process, thus stifling the Arizona competitive wholesale market. In sum, this proceeding has everything to do with preserving wholesale competition and the benefits this Commission repeatedly has said would follow as a consequence thereof.

What this case is not about is Pinnacle West Capital Corp. ("PWCC") or PWEC. This Application should not be decided on the basis of what is best for PWCC and its shareholders, nor on the basis of what is best for PWEC. The only pertinent inquiry under the governing law concerns whether APS has shown that approval of the Application would be in the best interest of APS's ratepayers.

In the pages that follow, PGR shows that APS has utterly failed to explain why, under the governing statutes and Commission rules, it should be allowed to loan half a billion dollars to its unregulated generation affiliate, PWEC, or alternatively to provide a corporate guarantee backing a third-party loan to PWEC in this amount. Indeed, rather than proving its case with facts, and satisfying what plainly is its statutory burden here, APS has relied instead on a combination of speculation, unsupported assertions, or obvious hyperbole – all of which was exposed and fully rebutted during the hearing – in order to persuade the Commission that the Commission itself caused PWEC's current problems and, therefore, that it is incumbent on the Commission itself to somehow find a way to approve this Application. PGR, however, is confident that the Commission will remain focused on the law, no matter how strident APS's rhetoric, and regardless of APS's not-so-subtle suggestion that it would be so much easier were this case just to go away. Hence, PGR also is confident that after holding APS to its burden of showing why the requested financing would be in the public interest, the Commission will conclude without reservation that APS has not sustained its case for either a loan or a guarantee. The evidence is just not there. Nevertheless, if, the Commission is inclined to approve any aspect of the Application, it is imperative for the protection of APS's ratepayers and the competitive wholesale market that the Commission only authorize a guarantee in the form described below.

Indeed, if there is the slightest question in the Commission's mind as to which alternative would best preserve the prospect for meaningful wholesale competition, the guarantee option is all the more appropriate given APS's contention in the hearing that, while it preferred being able to loan the money itself to PWEC, it could accept being authorized only to proceed with its guarantee alternative; and the evidence did show,

unquestionably, that a corporate guarantee would relieve PWEC's problems while posing the least potential detriment to the Track B competitive procurement process, while preserving the benefits of the competitive market for APS's ratepayers, and without the Commission having to pre-judge or even consider the issue of whether the PWEC assets should be included in APS's rate base.

PGR recognizes that Decision No. 65154 created unique issues, and that as a consequence of that decision, PWEC may need to revise its business structure. But Decision No. 65154 also changed much for PGR and Arizona's other competitive power suppliers. Like PWEC, PGR built merchant generation in Arizona. Like PWEC, PGR also wants to serve APS's load, and like PWEC, PGR built its assets at a time when the Commission's rules clearly required APS to acquire 100% of its needs from the competitive market. Clearly PGR never anticipated selling virtually its entire output to APS (something APS claims, without offering any contemporaneous evidence in support, that PWEC intended to do).[1] But PGR did expect to compete successfully to serve a significant portion of APS's 6000 MW load, and PGR did rely every bit as much as did PWEC on the expected implementation of all aspects of the state's Electric Competition Rules prior to Decision No. 65154.

In any event, the Commission's commitment to wholesale competition has not changed; and although Decision 65154 did significantly reduce the amount of load subject to competition in the near term, it also reinforced this Commission's commitment to wholesale competition, stating

[1] In fact, the Commission already had received evidence before this hearing that this was not the case. Prior to the Track A Special Open Meeting at which the Commission eliminated the divestiture requirement, the Arizona Competitive Power Alliance produced voluminous contemporaneous evidence showing that PWEC built and promoted the Redhawk and new West Phoenix units as merchant facilities.

> [w]e believe that requiring some power to be purchased through the competitive procurement process developed in Track B will encourage a phase-in to competition, encourage the development of a robust wholesale market for generation, and obtain some of the benefits of the new Arizona generation resources, while at the same time protecting ratepayers.

Decision No. 65154 at 30, lines 13-15. It is PGR's fervent hope that the Commission not allow its resolution of this proceeding to undermine this commitment in any way.

II. APS DID NOT SATISFY ITS BURDEN OF PROVING THAT ITS FINANCING PROPOSAL IS IN THE PUBLIC INTEREST

APS filed its Application "pursuant to A.R.S. §§ 40-285; 40-301, *et seq.*; and A.A.C. R 14-2-804." Application at 1. APS argued that the Application was "filed to address the serious and unique financial harm faced by APS, PWEC and Pinnacle West [PWCC] as a result of the Commission's 'reversal of course' on the issue of APS generation asset divestiture . . . and their detrimental reliance on the promise of divestiture made in a Commission-encouraged, approved, and adopted Settlement Agreement ("1999 Settlement")." Application at 2. It is against this statutory and regulatory backdrop that APS's Application must be tested.

A. Statutory Standard

A.R.S. § 40-301(B) states "[a] public service corporation may issue stocks and stock certificates, bonds, notes and other evidences of indebtedness payable at periods of more than twelve months after the date thereof, only when authorized by an order of the commission." The statute further provides that

> [t]he commission shall not make any order or supplemental order granting any application as provided by this article unless it finds that such issue is for lawful purposes which are within the corporate powers of the applicant, are compatible with the public interest, with sound financial practices, and with the proper performance by the applicant of service as a public service corporation and will not impair its ability to perform that service.

A.R.S. § 40-301(C). Thus, APS's Application must be rejected unless APS first proves that the loan and/or guarantee is (1) within APS's corporate powers; (2) in the public interest; (3) consistent with APS's role as a public service corporation; and (4) will not impair APS's ability to meet its obligations as a public service corporation.

In addition, because APS proposes to issue debt or a corporate guarantee to a non-utility affiliate, it must also comply with the Commission's Affiliated Interest Rules, which provide that

> [t]he Commission will review [designated transactions, including loans by a utility to an unregulated affiliate] to determine if the transactions would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service.

A.A.C. R14-2-804.

In its Application, APS requested a waiver of the Affiliated Interest Rules to the extent necessary to proceed with the proposed transaction. Application at 16-17. However, the Commission should be particularly reluctant to waive the Rules here, given that they were adopted in the first instance to protect ratepayers from the very risks at issue in this docket, namely, the risks associated with non-utility investments by unregulated affiliates of utility operating companies. Indeed, in its Concise Explanatory Statement accompanying the Rules, the Commission explained that

> The Rules were first promulgated in 1985 in response to the formation [of PWCC by APS] and to its acquisition one year later of MeraBank, a federal savings and loan institution. The Commission at the time expressed concerns that the transactions would prevent proper regulation and effect the establishment of rates for APS. In response, APS and its parent offered assurances to the Commission that the concerns were unfounded . . .
>
> The huge capital losses which have recently been experienced by MeraBank and have forced Pinnacle West to the brink of financial collapse served as the catalyst for the Commission to again engage in

> rulemaking for the regulation of public utility holding company formation and affiliated transactions. . .
>
> Article 8 is designed to ensure that utility ratepayers are insulated from the dangers proven to be inherent in holding structure and diversification. Its singular purpose is to ensure that ratepayers do not pay rates for utility service that include costs associated with holding company structure, financially beleaguered affiliates, or sweetheart deals with affiliates intended to extract capital from the utility to subsidize non-utility operations.

In the Matter of the Notice of Proposed Adoption of Rules to Provide for Regulation of Public Utility Companies with Unregulated Affiliates, Decision No. 56844, Attachment B at 2 (1990). The Concise Explanatory Statement also noted that the Rules were intended to implement the following principles:

> First, utility funds must not be commingled with non-utility funds. Second, cross-subsidization of non-utility activities by utility ratepayers must be prohibited. Third, the financial credit of the utility must not be affected by non-utility activities. Fourth, the utility and its affiliate must provide the Commission with the information necessary to carry out regulatory responsibilities.

Id. Thus, APS's assertion that APS's credit rating will be adversely affected if it is not permitted to loan half a billion dollars to its non-regulated affiliate is clearly an action that the Affiliated Interest Rules were intended to prohibit.

B. APS Failed To Prove The Elements Required By The Statutory and Regulatory Standards

As APS CEO Jack Davis testified, APS bears the burden of proof on each pertinent issue. Exh. APS-8 (Davis Rebuttal Testimony) at 9. But as Staff witness Thornton noted in his direct testimony, APS's case for its financing proposal under A.R.S. § 40-301 is weak at best and a "step backward for public policy . . .." Thornton Direct Testimony, Exh. S-1 at 6. Mr. Thornton testified that

> from a regulator's point of view, borrowing capital to lend to an affiliate is not obviously consistent with the provision of utility service. . . . I do not perceive the financing proposal as obviously compatible with the public interest without Commission conditions

> because APS would be incurring a large liability when it needs to seek and obtain debt capital for its own utility-related capital expenditures . . . The financing proposal is not obviously consistent with sound financial principles [and] is not obviously compatible with APS's proper function as a *public service company* without conditions . . .

Id. at 4-5. Mr. Thornton stated things more directly under cross examination:

> [m]y personal point of view was that if there were no other considerations in this docket, that a loan from a regulated utility to an unregulated company would generally, without any other information be regulatorily inappropriate.

Tr. at 945, lines 4-8. Staff ultimately concluded that the Commission should approve the proposed financing subject to a number of conditions and with the understanding that APS had agreed (or would agree) to drop much of its appeal of the Commission's Track A order. Nonetheless, anyone who heard Mr. Thornton's testimony had to go away thinking that he was very uncomfortable with the evidence APS presented to meet its burden of proof. *Id.* Indeed, APS completely failed to establish that the financing proposal met the requirements of the statute.

In its Application, APS argues that the requirements set forth in the statute are merely "boilerplate" language, to which the Commission need not necessarily be bound. Application at 15 (describing the statutory findings required by A.R.S. §§ 301-302 as "standard 'boilerplate' in all financing orders of the Commission"). In his rebuttal testimony, APS witness Davis urged the Commission not to "get hung up on parsing the very specific terms in Title 40 of the Arizona Revised Statutes," but rather to look to the benefits provided by the transaction. Tr. at 396, line 23. Likewise, while APS witness Barbara Gomez did at least list the standards in the context of attempting to rebut Mr. Thornton's determination that the standards were not met, she, too, provided no

documentary or factual basis for her assertions.[2] The only logical inference from its presentation, then, is that APS knew that its Application would not stand up against the regulatory and statutory requirements.

Rather than address the statutory and regulatory requirements, Mr. Davis listed eight "benefits" that he believed the proposed financing provided:

- Avoid downgrade of APS's debt ratings
- Avoid corresponding increases in APS's cost of capital
- Strengthen wholesale competition by maintaining PWEC as a viable competitor in the upcoming Track B solicitation
- Preserve the Commission's ability to consider rate base treatment of the PWEC assets during APS's 2003-2004 rate case
- Strengthen investor and rating agency confidence in the Commission
- Continue a responsive and responsible regulatory environment
- Preserve the current Track B solicitation process
- Result in settlement of most of the issues in the Track A appeal[3]

Setting aside for the moment whether APS proved that the financing proposal provides even one of these alleged "benefits," it is clear that none of these alleged benefits speak to any of the statutory or regulatory requirements.[4] APS failed to demonstrate that

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[2] When pressed, Ms. Gomez repeatedly deferred questions to her attorneys or other witnesses. On cross-examination, she referred questioners to Mr. Davis no fewer than twenty times. *See, e.g.* Tr. at 138, 152, 173. As discussed above, however, rather than testify about the Commission's statutory mandate, Mr. Davis claimed that the Commission need not get hung up on the precise language used in Title 40.

[3] Exh. APS-8 (Davis Rebuttal) at 8.

[4] While many of APS's assertions are outside the scope of this proceeding, (e.g., why Redhawk was built), given APS's position that any failure to rebut them indicates that the assertions must be true, PGR presents herein testimony and exhibits rebutting these assertions, too. *See*, Transcript of August 27, 2002 Special Open Meeting at 41, line 25 – 42, line 10.

the proposed loan and/or guarantee was within its corporate purpose; it failed to establish that the proposed financing would not impair APS's ability to perform its duties as a public service corporation; and its assertions about the financing's presumed public benefits were superficial at best. APS instead focused on what it claimed were the origins of its current financial predicament and the unsubstantiated benefits it claimed PWEC was created to provide, and has provided to APS's ratepayers.

1. APS's asserted grounds for approval

APS has asserted two principle bases for Commission approval of the Application. First, APS has stated repeatedly that it needed to refinance the PWCC bridge debt at APS as a direct consequence of the Commission's decision in the Track A Order, which eliminated the divestiture requirement of the Electric Competition Rules and the 1999 APS Settlement Agreement. For example, in its Application, APS claims that

> The impact of Decision No. 65154 on PWEC is both inequitable and dramatic . . .the Commission-induced financial disruption of the Company's parent corporation and generation affiliate, when combined with the unilateral revision of the 1999 Settlement in Decision No. 65154, would undoubtedly add a substantial regulatory risk premium to the Company's cost of obtaining and retaining capital.

Application at 4, 6. APS concludes, therefore, that the Commission should approve the financing proposal in order to remedy the harm caused by Decision No. 65154. Exh. APS-1 at 24. Specifically, APS argues that, while APS would not be harmed if the financing proposal is approved, if the Commission were to reject the Application, PWCC and APS both would suffer credit downgrades and increased costs of capital, that, but for the Commission's Track A Order, they would not have experienced. Application at 6-7.

Consequently, it argues that the financing proposal is in the public interest because it would prevent harm to the utility and its ratepayers.

Second, APS claims that PWEC was created as a result of the 1999 Settlement; that it would not have been created but for the Settlement; that it constructed generation only because APS was barred from doing so under its "Commission-imposed" Code of Conduct; and that its objective in doing so was first and foremost to serve APS customers. Exh. APS-8 at 4-7. APS argues that this makes PWEC fundamentally different from other merchant generators and that the Commission, therefore, should protect PWEC and ensure the continuation of these benefits to APS ratepayers. In sum, none of APS's arguments relate to the statutory findings the Commission must make in order to approve the Application but, in any event, as we next show, these arguments are speculative and wholly unsupported by the record.

2. There is no evidence in the record that PWCC will suffer a downgrade if APS does not refinance the bridge debt

APS argues that, because the PWEC assets are currently financed through bridge debt at PWCC that will mature in the near future, if the debt is not refinanced by APS, PWCC's credit will be downgraded by the rating agencies. Application at 6, Exh. APS-1 (Gomez) at 10-11. APS further argues that a credit downgrade of PWCC will result in a subsequent downgrade of APS. *Id.* As support, APS refers to rating agency releases stating that the current rating for PWCC is based on an assumption that the Commission will approve the instant financing proposal. While APS witness Gomez testified that rating agencies "routinely" downgrade utility subsidiaries upon a downgrade of the parent company, referring to the downgrade of Allegheny Energy's operating company subsidiaries after downgrade of the parent, she could cite only this single example in support of her assertion. Tr. at 186, lines 4-12.

APS introduced *no* written evidence that PWCC would be downgraded if it refinanced or renegotiated the bridge debt at the holding company level, nor any evidence that such a refinancing or renegotiation is impossible. Rather, Ms. Gomez relied on undocumented and unsubstantiated conversations she allegedly had with lenders and rating agency personnel during the course of which, or even after which, she failed to take a single note. Tr. at 114, lines 3-6. Even though Ms. Gomez had to have known that APS eventually would require this Commission to approve this refinancing, none of her conversations were memorialized in writing, none were reflected in any written correspondence, and none were the subject of internal e-mails, memoranda or other communication. *Id.* In short, Ms. Gomez could produce no evidence to back up her assertion that PWCC would be downgraded if it refinanced the bridge debt at the holding company level.

The only evidence in the record of any written analysis regarding PWCC's ability to refinance the bridge debt was produced by PGR witness Susan Abbott, a former Moody's analyst with twenty years experience rating utility companies, including APS. Ms. Abbott testified that were she analyzing PWCC, she would not recommend a rating downgrade were PWCC to refinance the bridge debt, concluding that PWCC's credit metrics would remain within the BBB range. Exh. P-22 at 11. There was no serious rebuttal of Ms. Abbott's analysis. Unquestionably, no contrary analysis was presented, even though APS surely had the opportunity to present its own analysis and its own "ratings" witness.

Ms. Abbott further testified that PWCC would likely be able to refinance or renegotiate the bridge debt even today, notwithstanding the present financial uncertainty in

the utility industry. Tr. at 777.[5] Indeed, a refinancing would be consistent with a number of the recent industry refinancings identified in the Wall Street Journal article attached to the Staff memorandum filed in Docket No. E-01345A-02-840. Again, APS presented no evidence to rebut Ms. Abbott's testimony that refinancing at PWCC would be possible without harm either to it or to APS. In fact, on cross-examination, APS's counsel elicited additional corroboration of Ms. Abbott's opinion when he focused Ms. Abbott's attention on "Pinnacle West Energy Corporation's ability to service $500 million in debt" Tr. at 755, lines 10-12; on the fact "that SunCor Development is expected to contribute . . . between 80 to 100 million dollars per year of cash flow" Tr. at 759, line 24 through 760, line 1; and on the "cash flow from SunCor, El Dorado, APS Energy Services or any of the other Pinnacle West Capital subsidiaries . . .." Tr. 760, lines 13-15. With all this cash flow, it is unclear why APS would argue on behalf of its unregulated parent that the parent required APS to assist in refinancing its affiliate's debt obligation.

Finally, Ms. Abbott's testimony is supported by Ms. Gomez' and Mr. Davis' testimony that PWCC would "raise" $300 million over the next year based on their own credit to complete the Silverhawk facility in Nevada. Tr. at 283, lines 4-8. Ms. Gomez was unable to explain how PWCC could independently obtain $300 million in new financing for its Nevada generation but must turn to its regulated affiliate, APS, to refinance $500 million in existing obligations for its Arizona generation.

[5] Ms. Abbott testified that "refinancing" and "financing" are to be distinguished as "the term financing indicates that there will be additional debt that is taken on. Refinancing means that you just take what you've already borrowed and reborrow it. So your leverage doesn't increase." Tr. at 777, lines 20-23.

3. There is no evidence in the record that APS will suffer a downgrade if PWCC is downgraded

As discussed above, APS witness Gomez testified that, as was the case with Allegheny Energy, if the rating agencies downgraded PWCC, they likely would downgrade APS as well. Again, aside from Ms. Gomez' unsubstantiated and uncorroborated testimony, APS offered absolutely no evidence to support this assertion. Indeed, although Ms. Gomez cited but one example of a situation where a downgrade of a holding company resulted in a downgrade of the utility subsidiary, she provided no evidence that even that situation truly was apposite to the instant case. Tr. at 186.

PGR witness Abbott, on the other hand, testified that in her 20 plus years of experience in assessing utility ratings, a downgrade of a holding company results in a downgrade of the utility subsidiary only where the parent's debt load is so high as to require substantial dividends from the utility company to allow the parent to continue to be able to service the debt. Tr. at 745, line 17 – 746, line 10. Inasmuch as PWCC would merely be replacing $500 million in bridge financing with $500 million in permanent financing, there would be no change in debt load at the parent level and, therefore, no need for a substantial dividend payment by APS. *Id.* Consequently, even if there were a downgrade of PWCC, there is no reason to believe this would result in a downgrade of APS.[6] It is therefore simply untrue, and certainly not shown in this proceeding to be even likely, that APS would suffer any harm even if PWCC were to be downgraded; all the evidence in this proceeding indicates that APS would not be harmed in such a situation.

[6] In addition, Staff witness Thornton testified regarding his experience in Oregon, where the Oregon Public Utilities Commission, through conditions required in approving the Enron-Portland General Electric merger, was able to prevent financial harm to PGE, even after its parent company collapsed and declared bankruptcy. Tr. at 917, line 17 – 918, line 8.

4. Any evidence that APS will not be downgraded if it were to make a loan either is not credible or is entirely self-serving

In addition to claiming that APS would suffer a credit downgrade if the financing application is not approved, APS also claims that APS would *not* suffer a downgrade if it assumes an additional $500 million in debt. Application at 14. As support for this assertion, APS provided statements from ratings agencies that APS's rating outlook was stable even if it made the loan to PWEC. Exh. APS-5, 6. However, as PGR witness Abbott testified, the analysis of the rating agencies depended, at least in part, on what APS told the rating agencies. Tr. at 742-743. Unfortunately, Ms. Gomez stated that she could not recount exactly what APS told the rating agencies immediately prior to the analysis upon which APS so heavily relies. She did, however, admit that she sent a copy of her testimony in this proceeding to the rating agencies before they issued their reports, testimony that clearly states that APS intends to ask the Commission to allow APS to put the PWEC assets in its rate base in its 2003-04 rate case. Ms. Abbott similarly testified that the ratebasing of the PWEC assets was likely discussed by APS. Tr. at 742. Consequently, there is no evidence whatever as to what the rating agencies would think were the assets not to be rate based, and it is entirely incorrect, therefore, to assume that their "analyses" would not change were the assets not put in APS rate base. The fact is that Ms. Abbott offered the only credible testimony on this point, and she testified, quite clearly, that if she were analyzing the transaction, using her 20 years of experience doing just such analyses, she would recommend a rating downgrade for APS if it loaned $500 million to PWEC. Tr. at 741-742.

Moreover, the relevance of any prior rating agency statement is further questionable given that APS appears to have provided inaccurate information to the rating agencies and analysts in the past as well. Shortly after the 1999 Settlement and after PWEC

proposed constructing generation assets, APS and PWEC told the rating agencies that PWEC and APS either had, or would, enter into a four-year Power Purchase Agreement ("PPA") for the supply of APS's power requirements, even though the final two years of the PPA would be *after* the date when APS was required to procure 100% of its Standard Offer Service requirements from the competitive market rather than from its unregulated merchant affiliate. Exhs. P-23, 24 and 25. On cross-examination, Ms. Gomez admitted that there really was no such PPA, and that APS merely told the rating agencies that it "expected" to sell power under just such a contract. Tr. at 145-146. The documents offer no such qualification, and it is reasonable to infer, therefore, that had the agencies been provided more accurate information, they likely would not have opined as they did.

In any event, even if APS is not downgraded as a result of making a loan to its affiliate, its credit quality will nonetheless suffer. PGR witness Abbott testified that APS's overall credit quality would be degraded, even if it remained within the metrics required to maintain its current credit rating. Tr. at 752, lines 1-5. Ultimately, any degradation in APS's credit quality will make procuring and retaining capital more expensive. Staff witness Thornton agreed, testifying that APS's overall credit quality would be degraded, and that even if a credit downgrade were not imminent, any future problems at APS would make a downgrade much more likely. Tr. at 992, lines 15-20. Again, APS provided no evidence to rebut the conclusion that APS's credit quality would decline, even if its actual credit rating remains intact.

5. The evidence demonstrates that the PWEC assets were built to serve the wholesale market, not APS ratepayers

APS argues that it is appropriate for APS to refinance debt related to the PWEC assets because PWEC would not have been created but for the Competition Rules' divestiture requirement, APS's Code of Conduct and the 1999 Settlement. Exh. APS-8

(Davis) at 4. Mr. Davis went even further, asserting "[n]o merchant generator built its entire business upon the notion that it had a responsibility to plan for and subsequently serve APS customers prior to seeking markets elsewhere." *Id.* at 4, lines 20-23. As a result, APS argues that the financial situation caused by the Commission's order reversing the divestiture requirement justifies the loan and/or guarantee proposal. Exh. APS-1 at 24 (describing PWEC's financial situation as "a problem the Commission largely created in the first instance").

Mr. Davis' assertion in this regard provides an example of the illusory "separation of interests" between APS and its generation affiliates otherwise required by the Commission's Affiliated Interest Rules and decisions related to electric restructuring. Not only are APS's claims not supported by any evidence, but they are flatly contradicted by every piece of contemporaneous evidence that touches on the subject. While APS undoubtedly anticipated sales by PWEC to APS, as did PGR and other merchant generators, all of the contemporaneous evidence indicates that PWEC was primarily geared to make sales in the broader wholesale market.

For example, when APS and PWEC applied for a Certificate of Environmental Compatibility ("CEC") to construct the Redhawk plant, they told the Commission that the plant would operate as a "merchant plant" and would sell its output in the wholesale market. Redhawk CEC transcript at 177-178, of which the Hearing Officer took Judicial Notice; *see also* Tr. at 404. APS never informed the Commission that the facility was built primarily to serve APS load going forward, or that PWEC was building the facility only because APS could not do so under its Code of Conduct.[7] Furthermore, both Redhawk

[7] APS witnesses testified that they never sought an opinion from the Commission to confirm their assertion that APS could not construct generation "needed to serve APS load."

and the West Phoenix expansion were originally contemplated as joint ventures with merchant generators like PGR. Exh. P-17. Thus, when Pinnacle West announced its plans to build the facilities with Reliant and Calpine respectively, it portrayed the facilities as merchant plants that would sell power into the Western competitive wholesale markets. *Id.*

APS's generation plans in 1999 and 2000 likewise indicate that PWEC intended to sell power throughout the Western States Coordinating Council ("WSCC") from these two facilities. Exh. P-12, 13. These documents reveal that Pinnacle West had a two-pronged generation plan – its generation facilities would sell power to APS, but would also pursue a Pinnacle West strategy to drive profits higher through sales into the regional wholesale market. The 2001 Pinnacle West Energy Plan, for example, states that "[d]emand growth is robust in the West, especially in Nevada and in the Arizona-New Mexico-California sub regions. PWEnergy's plan is geared to capture part of this growth potential." Exh. P-13 at 6. The parent company clearly saw PWEC as a significant resource for generating new revenue and increasing profit. This enhanced profit stream would not have been available were the PWEC plants primarily intended to sell power back to APS at prices equivalent to those that APS ratepayers would otherwise have paid for sales from APS-owned plants.

Similarly, APS's and PWEC's presentations to investors and rating agencies clearly show that PWEC viewed the entire WSCC as the target market as for these plants, as also is the case for its Silverhawk facility under construction in Nevada. The site for the Hedgehog project (later to become Redhawk) was selected because it offered easy access to the Palo Verde switchyard, a liquid hub for sales to California and other Western markets. Redhawk CEC transcript at 78, Exh. P-16. When developing the facilities, PWEC told investors and analysts that the WSCC market was primed for growth, and suggested that

PWEC would sell to that market. Exh. P-13. APS and PWEC made similar contemporaneous statements to Pinnacle West's shareholders. In the 1999 Annual Report, Pinnacle West told its shareholders that it had entered into a joint development agreement with Reliant to construct new "merchant plants" and that it intended to contribute Redhawk units 1 and 2 to the new merchant venture. Exh. P-10. In its 2000 Annual Report, Pinnacle West told shareholders that it expected PWEC to sell power to Pinnacle West Marketing and Trading and that "Power Marketing, in turn, is expected to sell power to APS and to non-affiliated power purchasers." Exh. P-11.

APS witness Davis claimed that certain presentations APS made in 2000 and 2001 show that PWEC intended primarily to serve APS customers, and that the output of the plants was "dedicated to" APS's customers. Tr. at 669-671. However, these very documents also indicate that APS always intended to transfer Redhawk units 1 and 2 to the Reliant joint venture, and not just to transfer units 3 and 4 as APS now claims. Exh. APS-23 at 3; Tr. at 1101, line 16 – 1102, line 16. Furthermore, while the APS exhibits do speak of sales to APS, it is just as clear that PWEC intended to sell the facilities' output primarily into the regional wholesale market, where it thought the returns would be commensurately greater. In fact, Mr. Davis's testimony is belied as well by Ms. Abbott. She testified that she had attended some of the rating analyst presentations and that

> [b]ased on my reading of the rating agency and financial community presentations made over the last few years by PWCC, it's my opinion and I always believed that the financial community and the rating agencies would have understood that such presentations were evidence of PWCC's intent to reap the benefits of the competitive market through its low-cost generation fleet, and that the real attraction for PWCC of ownership of PWEC was the potential to extract healthy economic rents from the wholesale power markets over time.
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> Detailed discussions in these various presentations of the dynamics of the WSCC and the position of APS/PWEC generating assets in that

market make it difficult for me to see that there was any other than that as the original intent.

Tr. at 745, lines 4-16. Even Mr. Davis conceded that there is no long-term contract or any written understanding even now that dedicates the output of the Redhawk and new West Phoenix units to APS, and that any non-affiliated generator could dedicate its plant's output through a contract with the utility. Tr. at 717, lines 12-13.

There is likewise no evidence or, for that matter, any reason to believe that APS could not have built the PWEC facilities and transferred the merchant units eventually to PWEC along with APS's other generation facilities, as was envisioned in the 1999 Settlement. It is not as though APS was forbidden to own any plants, post-settlement, that were intended both to sell into the wholesale market and to serve APS load. Mr. Davis himself conceded that during the period prior to divestiture, APS made off-system sales from its retained rate-based generation, and that these sales have continued "for as long as [Mr. Davis] has been with the Company." Tr. at 519. APS presented no evidence to show why such off-system wholesale sales by APS were permissible, under the APS Code of Conduct, but similar sales from Redhawk would be impermissible competitive activities. PWEC did not build the facilities because APS's Code of Conduct required it; PWEC built the units because it was a merchant generator and the facilities were intended to be merchant facilities from the beginning.

6. APS's eight "benefits" are either unsupported by the evidence or achievable though a PWCC refinancing

As discussed above, APS witness Davis listed eight benefits that he claimed are provided by the financing proposal, thus making the proposal in the public interest. These benefits are all either irrelevant to this proceeding or unsupported by the instant record. APS claims that the financing plan would avoid a downgrade of APS's credit rating and lead to a lower cost of capital for APS. As noted above, though, the evidence actually

shows that APS's credit quality would suffer even if APS's credit rating did not go down after making the loan to PWEC. *See, e.g.* Tr. at 992. Furthermore, there is no documentary or other substantial evidence to support APS's claims that refinancing at PWCC would result in a downgrade of APS.

APS also claims that the proposed refinancing would maintain PWEC as a viable wholesale generator, strengthen regional wholesale competition and preserve the Commission's ongoing Track B solicitation process. These claims also are demonstrably untrue. The Commission's Track B process will continue whether or not PWEC is a "viable" competitor, and whether or not it has access to ratepayer financing not available to other competitors. Furthermore, APS has stated repeatedly that it plans to move the PWEC units into APS rate base as soon as its 2003 rate case, and goes so far as to argue that approval of the loan and/or guarantee would preserve APS's opportunity to move the assets into its rate base. However, as Mr. Davis' testimony in this proceeding clearly indicates, if APS were allowed to include the Redhawk and new West Phoenix units in rate base, there would be almost *no* contestable load for which APS must solicit competitive wholesale generation. Exh. APS-19. Hence, if it wishes to preserve a viable competitive market, the Commission should maintain the greatest separation possible between APS and PWEC.

Finally, APS claims that approval of the financing proposal would strengthen investor confidence in the Commission and allow settlement of much of APS's Track A appeal. Whether or not investors have "confidence" in the Commission certainly helps Pinnacle West's bottom line, but does little or nothing for APS or its ratepayers. More importantly though, Wall Street's confidence in this Commission will depend not only upon how this Commission treats APS, PWEC and PWCC here, but perhaps even more

importantly, on whether and how the Commission maintains the viability of the state's wholesale market for the numerous wholesale generators who have constructed billions of dollars of facilities in Arizona to serve the state's standard offer ratepayers, as precisely was envisioned under the Electric Competition Rules and the 1999 Settlement. The Commission's mandate is to protect utility ratepayers and to ensure that they are provided the most economic and clean electricity possible, not to ensure ambiguous investor confidence in outcomes positive for one utility holding company.

Lastly, given that both APS and Staff (the only parties to the proposed Track A Principles for Resolution) argue that the Commission should not consider their settlement memorandum in this proceeding, Tr. at 65, line 8, settlement of the Track A appeal is irrelevant, and cannot serve as a basis for finding the financing proposal to be in the public interest.

In sum, APS has presented no evidence that APS or its ratepayers would be harmed were the financing proposal to be denied, and has presented no evidence of any benefit to APS or its ratepayers were the financing proposal to be approved.

III. IF THE COMMISSION ELECTS TO PROVIDE PWCC WITH SOME RELIEF, IT ONLY SHOULD ALLOW APS TO ISSUE A GUARANTEE

As established above, APS has not met its burden of demonstrating that its proposed financing application is in the public interest. Nevertheless, if the Commission is disposed to allow affiliate financing between PWCC subsidiaries, the Commission should restrict the financing arrangement to the one that would tend to best maintain the separation of the regulated and unregulated affiliates, preserve to the greatest extent possible the goals set forth in prior Commission Orders on electric wholesale competition – and the considerable work of the participants on Track B – and not prejudge, or even call upon the Commission to consider, the issue of whether the current PWEC assets should be

included in APS's rate base, or otherwise tend to render such outcome a *fait accompli.* Among the alternatives offered by APS's application, the APS guarantee of PWEC's debt would most closely align with these goals.[8]

A. In Its Application And First Round Of Testimony, APS Argued That A Guarantee Provided A Workable Solution To PWCC's Problems

In its application APS requested Commission permission to either loan PWEC or PWCC money directly, or to guarantee $500 million of PWEC debt. Application at 12. Its primary financial witness, Barbara Gomez, supported the guarantee option by asserting that a guarantee allows "PWEC to get its feet wet in the credit markets. This 'financial discovery' by the market may accelerate the day when PWEC can finance totally on its own." Exh. APS-1 (Gomez Direct) at 15, lines 13-15. In her rebuttal testimony, Ms Gomez stated that APS proposed the guarantee "because of its potentially reduced impact on APS and because it might provide PWEC some 'credit exposure' in the market that would be valuable in the future." Exh. APS-2 (Gomez Rebuttal) at 7, lines 1-3. Likewise, Arthur Tildesley of Salomon Smith Barney Inc. testified on behalf of APS that the guarantee, which would be provided to PWEC "until the time when PWEC would be positioned to obtain standalone financing on separate terms," has "the benefit of the notes being issued directly by PWEC." Exh. APS-3 (Tildesley Direct) at 8 – 9.

The guarantee-related testimony of Gomez and Tildesley focus on what should be the Commission's critical goal, establishing PWEC as a standalone entity as soon as possible. A direct loan from APS to PWEC would not advance that goal in any way, but would perpetuate the ties between the regulated and unregulated arms of PWCC. On the

[8] APS offered no explanation as to why PWCC could not guarantee PWEC's debt. As APS's counsel's questions to PGR witness Susan Abbott indicate, PWCC apparently has plenty of cash available to service the PWEC debt. Tr. at 757, line 25 – 759, line 1.

other hand, a corporate guarantee, while still resulting in a financial tie between the regulated and unregulated entities, would also provide a degree of separation, because PWEC would obtain its own financing with the assets of APS acting merely as a backstop.

Having once requested permission to issue a guarantee, and having expressed the many benefits of doing so, the Commission must question why APS would not now commit to resolving this matter by ceasing its pursuit of the loan alternative, and agreeing to be limited to the guarantee alternative. Tr. at 457. Indeed, it is a puzzlement. On the one hand Ms. Gomez testified that "we [APS] are in favor of an inter-company loan or . . . an APS guarantee. It really does not matter to us." Tr. at 200, lines 10-13. On the other hand in her rebuttal testimony, she said that "given the continuing challenges in the financial markets since the time the Application was filed, the guarantee option is more or less moot." Exh. APS-2 (Gomez Rebuttal) at 7. But at the hearing she retreated from this statement, testifying that "[a] guarantee is possible in today's market." Tr. at 208, lines 19-22.

In the hearing Ms. Gomez laid APS's reluctance to pursue a guarantee at the feet of Staff, saying that it was Staff's security condition that made a guarantee "moot." Tr. at 208, lines 8-10 and 19-22. Yet Staff witness Thornton testified that "Staff might consider a guarantee if it were more clearly defined and priced . . . [h]owever, Staff does not believe that the guarantee is APS's preferred option, so such authorization might be moot." Exh. S-1 (Thornton Direct) at 12, lines 21-23. Indeed, although continuing to state its support for use a guarantee, during the hearing, APS oftentimes made wholly unsupported statements about the complexity or cost of a guarantee. *See, e.g.* Tr. at 122, 293. And in addition to trying to throw up these hurdles, as noted above, while Ms. Gomez repeatedly testified on cross examination that the company would support either a corporate guarantee

or an inter-company loan, on redirect she testified that APS would prefer a loan. Tr. at 200 ("it really does not matter to us"), 292 ("we would prefer the inter-company loan").

APS identified three reasons for preferring a loan to a guarantee. First, there was the claimed complexity of the guarantee. Second, there was the additional layer of transactions that would have to be undone if the Commission were to allow APS to put the current PWEC assets in APS rate base; and lastly, there was Staff's preference. These "hurdles" are not the least bit pertinent to whether, assuming any part of the Application is approved, APS should be required to pursue the guarantee option here.

B. There Is No Evidence That A Guarantee Would Be More Complex, Difficult Or Expensive Than A Loan

APS's primary argument against a guarantee is that it would be more complex than a direct loan and may result in a structuring premium. Exh. APS-3 (Gomez Rebuttal); Tr. at 293, line 20 – 294, line 9. Like many of its other assertions, APS did not provide *any* documentary evidence to support the assertion that the guarantee option is more complex or costly. Ms. Gomez testified that she knew about any possible complexity at the time APS initially sought the right to issue a guarantee and at the time of her testimony listing the benefits of a guarantee. Tr. at 302, lines 16 -23. More importantly, Ms. Gomez specifically testified that any claimed complexity "was not an impediment to the company's willingness to consider a loan or guarantee. Tr. at 302, lines 24 through 303, line 2. In fact, Ms. Gomez testified that APS had used guarantees numerous times in other contexts. Tr. at 198, lines 8-15. The only conceivable "complexity" identified was that PWEC is not known in the credit market and that lenders would therefore require additional analysis and paperwork. Tr. at 293, line 20 through 294, line 9.[9] However,

[9] As noted above, this same unfamiliarity with PWEC was the "benefit" of doing a guarantee when that was what APS wanted.

APS's "lender" expert, Mr. Tildesley, was not so concerned about the "complexity" of the guarantee, stating

> It is not a typical structure. This is not a typical situation, and the use of a guarantee is not common. However, a guarantee in and of itself is fairly straightforward. So while it is not common and is not something that investors typically see, it's our view that ***undertaking the guarantee will not be terribly difficult.***

Tr. at 366, line 22 through 367, line 3 (emphasis added). Indeed, Mr. Tildesley testified that his company would certainly bid to structure and place the guarantee and could fill in any blanks that Commission Staff needed answered to evaluate the transaction, "at the request of [his] client." Tr. 367, line 19 through 368, line 2. Hence, all of APS's testimony supports Ms. Abbott's testimony that a guarantee would not be more complex than were APS to loan money directly to PWEC. Tr. at 741.

APS's arguments regarding the cost of a guarantee are similarly frivolous. Just like the alleged complexity of the transaction, the additional costs, if any, were known when APS first proposed a guarantee. Of equal importance, like all costs in this matter, any costs of pursuing a guarantee would be borne by PWEC and, therefore, are of no consequence to APS or its customers. Tr. at 318, lines 6-16. In any event, Ms. Gomez "estimated" these costs at $1 million a year, substantially less than the estimate of increased interest expense PWEC would pay under the loan scenario.[10] Even if there were proof for the assertions, given the stated benefits of a guarantee, the minimal expense (2/10th of 1%) is appropriate. Finally, Mr. Tildesley testified that his company could receive up to a $2

[10] It is assumed that PWEC's interest rate in the guarantee scenario would be whatever rate it could command in the market (with an APS guarantee), rather than the artificial rate created by Staff's recommendations. If Staff wanted to impose a risk premium above the PWEC-obtained rate to compensate APS for the risk of the guarantee, it could do so, either through a direct payment or through an escrow account to be accessed only if APS was called upon to repay PWEC's obligations. Tr. at 991, lines 14-24 (explaining that the purpose of the risk premium is to compensate ratepayers for the risk APS is exposing itself to through the inter-company loan).

million fee for placing the debt to support the inter-affiliate loan. Tr. at 342, line 19 – 343, line 1. But if a $2 million placement fee for an inter-affiliate loan is not excessive, a $1 million per year "premium," assuming there would even be a premium charged, seems a reasonable price to pay in order to allow PWEC to become a fully standalone company.

C. APS's Expressed Desire Eventually To Rate Base The PWEC Assets Should Not Prejudice Any Decision In This Docket; Nor Should the Outcome of this Docket Make that Rate-Basing More Likely

As a separate ground for why APS now prefers an inter-company loan rather than a guarantee, APS asserts that the guarantee would "create another element of structure that in the event that the assets are rate based, you have to undo that element, which gets it more complicated." Tr. at 293, lines 10-12. As Ms. Gomez went on to explain, in the loan scenario, to transfer the assets and seek rate base treatment, APS would simply "forgive the loan." Tr. at 294, lines 17-20. On re-cross, she tried to downplay the benefits of a corporate guarantee by asserting that the benefit of PWEC credit "no longer exists . . . primarily in relation to our proposal now to move ahead to rate base the asset." Tr. at 320, lines 2-5. Clearly then, APS now is assessing the merits of the two alternatives on the basis of which alternative would best advance the prospects of a future rate-basing of the PWEC assets. Clearly, this is why APS now refrains from pursuing the guarantee option. APS also suggests, at least by implication, that the Application should be assessed by the Commission on the assumption that the assets will in fact be rate-based. But PGR respectfully submits that the Commission must not assess the merits of the loan or guarantee options on the basis of which option makes it easier to rate-base the assets. On the contrary, the Commission, if it approves either option, should approve only the guarantee alternative precisely so as to *not* make it any more likely that the assets will eventually be transferred to APS.

In any event, Ms. Gomez affirmed that she knew of no reason a guarantee would prohibit APS from ultimately seeking rate base treatment of the PWEC assets. Tr. at 321, lines 3-8. Of equal import, the direct loan proposal appears to completely ignore what happens if the Commission does not grant rate base treatment for the PWEC assets. When questioned on re-cross as to whether PWEC would be in any better position to go out to the market and get its own financing in two to four years if it were to receive a direct loan from APS, but the Commission were not to approve any future rate basing, Ms. Gomez could offer no opinion that PWEC would in fact be in a better position having received the loan, as opposed to APS issuing a guarantee. Tr. 320, lines 16-22. Thus the Commission is faced with the choice of using a guarantee, which APS witnesses have testified advances the future potential of PWEC standing on its own two feet, or allowing an inter-company loan, the only apparent benefit of which is that it makes APS's desire to rate base the PWEC assets easier. With these facts and the Commission's objective to preserve a viable competitive wholesale market, it should be an easy choice for the Commission to select the corporate guarantee over the inter-affiliate loan.

Indeed, while providing no apparent benefits over a guarantee, the inter-affiliate loan has a significant potential to harm wholesale competition. APS's counsel tried to downplay this potential by suggesting that it requires the Commission to "speculate a fourth, fifth and sixth time" about future orders or conditions. But, as recognized in Decision Nos. 61973 and 65154, "the Commission must be able to make rule changes/other future modifications that become necessary over time." Decision No. 61973 at 9; Decision No. 65154 at 23. As APS witness Steve Wheeler himself said in the Track B hearing, the Commission must be cognizant of "unintended consequences" of its actions. Rebuttal Testimony of Steven Wheeler in Docket No. E-00000A-02-0051, et al.

at 11, lines 17-23. This entire financing matter would seem to be an unintended consequence of the 1999 Settlement as APS alleges that PWEC built $1 billion worth of merchant generation, financed with short term debt, entirely on the basis of the 1999 Settlement between APS and others and without ever informing the Commission or the other parties to the settlement of its intent. The Commission should not do anything that increases the likelihood of there being additional unintended consequences even if it does believe it must do something to rectify any problems arising out of the 1999 Settlement and the Commission's more recent orders on wholesale competition. Some of the potential unintended consequences of APS's current proposal are addressed below.

1. There is no apparent benefit to a loan over a guarantee with respect to the rate-basing of the PWEC assets

As noted above, APS "prefers" the loan over the guarantee for the sole reason that it would more easily support APS's ultimate goal of rate-basing the PWEC assets. APS also cites the potential to rate base the PWEC assets as one of the "benefits" of the financing application. No such benefit exists. This Commission has already determined that some wholesale competition is in the public interest and that APS's inclusion of the PWEC assets would not foster that competition. Decision No. 65154 at 30, lines 13-19.

Putting the PWEC assets in APS's rate base is the antithesis of promoting wholesale competition. As Jack Davis made clear, if the PWEC assets go into rate base they will all but eliminate APS's capacity and energy needs going forward. Tr. at 655. In answer to a question from Chief Hearing Officer Farmer, Mr. Davis essentially said that only the crumbs of competition would be left for the rest of the competitive market. *Id.* at 655, line 13 (the PWEC assets are about equivalent to APS's unmet capacity needs and could generate many multiples of its claimed unmet energy needs). Based on Mr. Davis' testimony, there is little question that rate-basing the PWEC assets would decimate

wholesale competition in Arizona. Hence, if approval of the loan option would make this rate-basing any more likely, it should be rejected in favor of the guarantee option.

Indeed, the devastating effects on the competitive wholesale market from rate-basing the PWEC assets are not simply a "hypothetical" concern espoused only by merchant generators. Gerard Klauer Mattison, in a stock analysis decision stated as follows regarding the potential rate-basing of PWEC assets

> we question why PNW [Pinnacle West] would choose to move its unregulated capacity into its regulated utility, with the possibility that these assets would not earn a return on the full investment. However, should the company choose to move the capacity and should the commission allow a return on the investment, it would appear to us that the commission would dramatically undermine the competitive wholesale market in Arizona, creating a negative environment for independent power producers that have built capacity in the state under the assumption there would be a competitive bidding process.

Exh. P-9. Thus, the almost certain, but at least likely, harm to wholesale competition and Track B from rate base treatment of the PWEC assets is real and recognized. In fact, a quick rejection of any suggested rate-basing of the PWEC assets only would "strengthen investor and rating agency confidence in the Commission." APS-8 at 3.[11]

The point, though, is that while the Commission does not have to, and need not "decide" the rate base issue in this case, given the clear detrimental effect that any such rate-basing would have on wholesale competition, it is hard to fathom how APS can claim that protecting the potential to rate base the PWEC assets is a "benefit" of the financing application, much less argue that it is a, if not the principle basis for selecting a inter-company loan over a guarantee.

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[11] As discussed above, strengthening investor confidence in the Commission has nothing to do with whether this proposed transaction is in the best interest of APS or its ratepayers. However, to the extent the Commission deems investor confidence to be an appropriate issue to consider, approval of the guarantee option clearly would do more to strengthen overall confidence that the Commission remains committed to a competitive wholesale market than would approval of the loan alternative.

2. A loan can harm wholesale competition were PWEC to default

The potential to harm wholesale competition is not simply a function of whether or not the PWEC assets are ultimately put in APS's rate base. The potential harm to wholesale competition can be created by the loan itself and by a default under that loan. PGR raised the issue of a loan default and the transfer of the PWEC assets to APS during the proceedings on APS's $125 million financing request. While Commissioner Spitzer expressed a similar concern (Transcript of Special Open Meeting at 51) the Commission determined that it did not need to address the issue in the context of that proceeding. Since APS has been much clearer about its ultimate goal with regard to the PWEC assets, the Commission should no longer defer its consideration of the impact on the wholesale market.

APS claims that three factors will prevent PWEC from simply defaulting on an inter-company loan. First APS asserted that the potential for cross defaults being declared on $1 billion of PWCC debt would prevent PWEC from defaulting. Tr. at 82, lines 5-13. When asked by APS counsel to identify the debt instruments containing the cross-default provisions, Ms. Gomez identified only $450 million in PWCC debt. Tr. at 327, lines 1-8. Of this $450 million, the $300 million CSFB bank loan facility expires in July 2003, and the $125 million revolving debt facility with J.P. Morgan expires in December 2004. Thus, as of the end of 2004, the only PWCC debt that would be immediately callable upon default to APS by PWEC would be a $25 million loan from Prudential.

Even if the $425 million in expiring debt is renewed with identical cross-default language (particularly unlikely, given that the PWEC-APS loan would be merely an intra-company transaction), the cross-default provision in question merely provides that the lender *may* declare the debt to become immediately due and payable. *See*, APS "Emergency Application" filed in Docket No. E01345A-02-840, Attachment B at 23.

Such cross-default provisions are routinely waived by lenders. This would be expected to be particularly likely here, where the default triggering the cross defaults is simply an inter-company transaction.

Second, APS argued that the Deeds of Trust that would define the security interest between APS and PWEC with regard to the PWEC assets allow APS the opportunity to call upon the Deeds of Trust to get its money back though a trustee sponsored auction. Ms. Gomez asserts that the assets "do not just automatically get . . . transferred to APS." Tr. at 82, line 21 – 83, line 9. While a trustee sale is one option upon an event of default, the Deeds of Trust also permit APS to "enter upon and take possession of the trust estate." Deed of Trust at 9, paragraph 1.10. There is little practical difference between the assets "automatically transferring" and the right of APS to enter upon and take possession of the trust estate.

On the other hand, if the Commission selects the guarantee option, the Commission would not have to worry about the potential for the assets to automatically move to APS as PWEC's lender would be the entity with the right to possession and sale. This should pose little concern to APS unless it anticipates a default prior to its effort to seek rate-base treatment, and that default is not cured by PWCC, and thus the lender chooses to sell the assets. Obviously, though, worrying about such likelihood would entail engaging in several degrees of speculation.

Finally, APS argued that "once . . . a part of a company defaults on a loan, it puts a black eye across all companies," increasing the capital costs for the entire enterprise. Tr. at 84, lines 2-5. It is not clear why the enterprise would get a financial black eye from a default by one affiliate on an obligation to another, particularly where, as here, the effect is

to transfer the PWEC assets to APS, which PWEC and APS have already stated they intend to do.

3. A loan itself can harm wholesale competition

Even without a PWEC default, the direct inter-company loan has the potential to adversely affect wholesale competition, because APS would have a strong incentive to prefer its affiliate in the upcoming competitive solicitation. This is true not only to support its repayment of the loan, but also to establish a case for ultimate rate-base treatment of the PWEC assets, a professed goal of the loan application. While the guarantee would not completely eliminate the preference, it may substantially reduce the likelihood of its being expressed, as the loan payments will be going to another entity, not APS. Likewise, default under a guarantee would not result in an automatic transfer of the PWEC assets to APS.

D. Terms Of The Guarantee

PGR believes that there are three critical terms to any guarantee. First the PWEC assets must be pledged as collateral for the loan. Second, the lender must execute on the assets prior to seeking payment from APS. Third, APS should not be permitted to bid on the assets in the event of a PWEC default and subsequent sale of those assets. Each of these terms is necessary to ensure that APS ratepayers are protected and that PWEC has an incentive to pay its debt obligation. And each of these terms is all the more reasonable, given the fact that even the guarantee option is not plainly required by the public interest.

1. PWEC assets should be pledged as collateral for a third-party loan to PWEC

Despite the fact that there was no evidence produced in this proceeding that PWEC or PWCC ever made an offer to pledge the PWEC assets as collateral in an effort to obtain a conventional loan, PWEC quickly agreed to pledge those assets to APS to secure the proposed inter-affiliate loan. Of course such a pledge was made in that instance

because it supports the overall goal of moving those assets to APS. Given that PWEC apparently is not now opposed to using the assets as collateral for a loan, the assets should be pledged to a third-party lender as security for a loan, which is guaranteed by APS.

2. Upon a PWEC default, the third-party lender should execute on the PWEC assets before seeking payment from APS

To further protect APS ratepayers, the third-party lender should be required to execute on the PWEC assets prior to seeking payment from APS. This will assure that APS income is only affected if PWEC defaults and the assets are not worth the remaining loan amount. At the hearing, Mr. Davis testified that he believed the fair market value of the PWEC assets was in excess of $625 million and, from his experience, "they're worth a billion or something of that nature." Tr. at 570, lines 5- 20. If Mr. Davis' belief is correct, APS, and thus its customers, are at no risk whatever of being tapped to pay off the PWEC loan. This should be the type of arrangement APS would insist upon, if its focus were its bottom line and the protection of its customers. If APS is opposed to such an arrangement it can only be on grounds that benefit PWCC shareholders, not APS ratepayers.

3. In the event of a PWEC default and subsequent sale of the PWEC assets, APS should be prohibited from bidding on the assets

Finally, APS should not be permitted to bid on the PWEC assets should they be auctioned as a result of a future PWEC default. One of APS's stated goals is to move the PWEC assets into APS and ultimately APS's rate base. By prohibiting APS from bidding on the assets, the Commission would be sending the strongest possible message that PWEC should not simply default on its loan obligations. APS's assertion that this condition would result in the plants being lost to Arizona, implying that a sale to a third party would do just that, is simply ridiculous. Power plants don't just up and move. The new West Phoenix merchant facilities will be located at West Phoenix regardless of their

ownership and will be available to serve Arizona load. Again, PWEC's West Phoenix 5 originally was to have been jointly owned with Calpine and its Redhawk units #1 and #2 were to have been jointly owned with Reliant. Tr. at 530, lines 23-25.

In fact, such third-party ownership only would strengthen the competitive wholesale market in Arizona by providing more competitors, as initially envisioned by the Commission, rather than fewer, as APS would have it. It should be made clear however, that third-party ownership is *not* PGR's goal. The goal is for PWEC to be treated by APS as a "third-party" owner, for all purposes. This is consistent with the Commission's goal in initially requiring a separation of monopoly and competitive assets. The goal for APS should be that PWEC pay its debt without relying on APS or APS ratepayers.

IV. CONCLUSION

As discussed herein, APS has not met its burden of proving that its inter-affiliate financing proposal is in the public interest. To the contrary, the evidence demonstrates that a loan by APS to PWEC or an APS guarantee of PWEC debt would provide no benefit to APS ratepayers. Moreover, such a transaction would make it more likely that the PWEC assets would transfer to APS, thereby reducing both the amount of contestable load in any future solicitation and the prospects for meaningful wholesale competition in Arizona, which the Commission has previously determined *would be* in the public interest. Furthermore, the evidence demonstrates that PWCC clearly could refinance its existing bridge debt without adverse impact to the holding company or to APS ratepayers.

If, however, the Commission determines that some form of credit support to PWEC from APS is appropriate, it should approve the corporate guarantee option, not the direct loan alternative. Only the guarantee would address PWEC's problems while both protecting the Commission's Track A order and the Track B competitive procurement

process, and without the Commission's having, in any sense, to pre-judge or even to consider the issue of whether the PWEC assets should ultimately be transferred to APS and included in APS's rate base.

RESPECTFULLY SUBMITTED, Monday, January 27, 2003

By 

Larry F. Eisenstat
Michael R. Engleman
Frederick D. Ochsenhirt
Dickstein Shapiro Morin & Oshinsky LLP
2101 L Street, N.W.
Washington, DC 20037
(202) 828-2224
Attorneys for TPS GP, Inc.

On Behalf of Panda Gila River, L.P.

Jay L. Shapiro
Fennemore Craig
3003 North Central Avenue
Suite 2600
Phoenix, Arizona 85012
(602) 916-5000

ORIGINAL and 15 copies of the
foregoing hand-delivered for filing,
Monday, January 27, 2003:

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

Lyn Farmer
Hearing Officer
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

Chris Kempley, Chief Counsel
ARIZONA CORPORATION COMMISSION
Legal Division
1200 West Washington
Phoenix, Arizona 85007

Ernest G. Johnson
Director, Utilities Division
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

COPY of the foregoing mailed, faxed or
Transmitted electronically,
Monday, January 27, 2003, to:

All parties of Record

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